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Dealing with Deficits and the Rise in Federal Spending

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At a time when, alas, economist jokes are in vogue, I would like to add my favorite wisecrack about our profession: if all the economists in the world were laid end to end, it might be a good thing. This sour remark is instigated by my having to listen to, and occasionally participate in, what seem to be endless debates on whether budget deficits really matter, and, if so, on what arcane basis of measurement. I finally have found a short cut that reconciles the great intellectual wisdom of our profession with the practical concerns of participants in and observers of financial markets. Thus, I conclude that deficits do not matter—but that Treasury borrowing and money creation surely do!

Having disposed of this weighty subject so quickly, let me go on to examine several current policy questions relating to federal finance and to budget deficits. First, let us consider the nature of the changes made in federal outlays by the Reagan Administration and, second, let us analyze some of the economic implications, covering both military and civilian programs. This task, it turns out, is more complicated than one might expect.

How Much Has the Budget Been Cut?

To begin, it is difficult to directly compare the current estimates of outlays under the Reagan program with those contained in President Carter's last budget message, presented in January, 1981. Since

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then, the publications of the Office of Management and Budget have generally "adjusted" the Carter numbers upward for a change that it believes President Carter *should* have made—specifically providing for what is now considered to be an adequate national defense. That procedure does have its advantages. That is, by assigning the present Administration's increases in national defense to the numbers associated with the previous Administration, OMB can take credit for its cuts in civilian outlays while ignoring the increases in military outlays.

This means in practice that, if we want to compare Reagan with Carter, we must dig the Carter reports out of our archives and compare the data in them with the figures in the most current Reagan budget publications. I will note in passing that this is a chore that the average journalist working under a tight deadline may forego. In any event, I find such statistical explorations useful for those engaged in more leisurely scholarly pursuits.

OMB takes credit for cuts in civilian outlays, while ignoring military outlay increases

Table 1 contains a first effort to make such a comparison. It compares total outlays for fiscal years 1982-1986 as estimated in the last Carter Budget report with those shown in the most recent Reagan Administration budget report. It is clear that the Reagan spending totals in current dollars (unadjusted for progress on inflation) are lower in each year than the Carter figures. The current Administration's much slower growth in civilian spending more than offsets its increases in defense outlays, but by about one half of the 1981 tax cuts—about $350 billion versus over $700 billion for the five year period 1982-86.

More sophisticated comparisons can be made. For example, the comparison can be

TABLE 1
Reagan and Carter Budget Estimates
(Billions of Current Dollars)

Fiscal Year	Defense		All Other		Total		Difference
	Carter	Reagan	Carter	Reagan	Carter	Reagan	
1982	$184.4	$187.7	$554.9	$543.3	$ 739.3	$731.0	$ −8.3
1983	210.4	221.5	606.9	540.0	817.3	761.5	−55.8
1984	237.8	253.4	652.5	559.1	890.3	812.5	−77.8
1985	267.8	292.5	700.1	582.2	967.9	874.7	−93.2
1986	299.5	332.0	750.8	600.7	1050.3	932.7	−117.6

restated in terms of constant dollars, using in each case the inflation assumptions that accompanied the respective current dollar estimates. The results based on the GNP deflators are contained in Table 2. The differences between the two sets of projected outlays are very much smaller than in Table 1, about $23 billion when viewed in real (deflated) terms over the period 1982-86 (or a little less than $5 billion a year).

A variation of this theme is contained in Table 3, where the CPI assumptions are used to adjust both sets of outlay projections. In this case, the results are more ambiguous. Using the CPI as a deflator, the aggregate estimates for fiscal years 1982-1986 under the Reagan programs are shown on balance to be a bit higher than the Carter estimates—by about $7 billion (or a little over $1 billion a year).

In relation to the 1981 tax cuts, net spending reductions have been modest

It does seem clear that, especially in relation to the 1981 tax cuts, the net spending reductions in the past 20 months are modest. It is not surprising, therefore, that current projections of the budget deficit for the next several years are unusually high. See Table 4 for estimates by the Congressional Budget Office that are in the neighborhood of $150 billion a year. Unofficial forecasts of the deficit in the next few years range up to $200 billion annually.

The Problem of Entitlements

When we probe beneath the aggregate spending levels, we find that "entitlements" or payments to individuals constitute the largest category of the budget. In recent years, entitlement payments also have been the most rapidly growing budget category. It therefore is quite appropriate that

TABLE 2
Reagan and Carter Budget Estimates
(Billions of Constant 1972 Dollars, Using GNP Deflators in Respective Documents)

Fiscal Year	Amount		Difference
	Carter	Reagan	
1982	$345.0	$354.9	$ +9.9
1983	351.7	347.1	−4.6
1984	355.4	347.7	−7.7
1985	361.2	353.0	−8.2
1986	368.8	356.1	−12.7

TABLE 3
Reagan and Carter Budget Estimates
(Billions of Constant Dollars, Using CPI Deflators in Respective Documents)

Fiscal Year	Amount		Difference
	Carter	Reagan	
1982	$241.0	$253.5	$+12.5
1983	245.0	247.4	+2.4
1984	247.6	247.0	−0.6
1985	251.7	250.0	−1.7
1986	257.0	251.5	−5.5

TABLE 4
Projections of the Federal Budget
(Fiscal Years, Billions of Dollars)

	1982		1983	
	OMB	CBO	OMB	CBO
Outlays	$731	$733	$762	$788
Revenues	622	621	647	633
Deficit	109	112	115	155

	1984		1985	
	OMB	CBO	OMB	CBO
Outlays	$812	$844	$875	$910
Revenues	720	692	801	757
Deficit	92	152	74	153

increasing attention is being given to this area. I have little to add to the extensive public debate. I am, however, struck by the vast amount of ignorance attached to the largest entitlement, social security benefit payments.

Given the current focus on reducing those outsized budget deficits, any discussion of possible change in social security outlays is immediately attacked as an effort to balance the budget on the backs of social security pensioners. It is true that facing the problem of social security financing would likely result in smaller budget deficits. But—and this fundamental point is usually ignored—even if the federal budget were in such great shape that we could declare dividends out of the surplus, we would still have to face the basic problem that the social security system is not adequately financed.

We must face the basic problem that the Social Security system is not adequately financed

Over the years, Congress has been more aggressive in voting benefit increases than in enacting the social security tax increases to pay for them. Also, demographic and economic trends have turned out in recent years to be more adverse than assumed in the system's actuarial calculations. Thus, the public debate on social security has the issue backwards: our attention is needed on the question of social security finance, not because of the budget deficits but to ensure that the program fully meets the disbursements to which it is committed. We must recognize, however, that although it is the largest single "entitlement program," social security is only one of many. A comprehensive budget restraint effort must take a hard look at the other components in this category, including veterans' pensions and government employees' retirement benefits.

The Question of National Defense Spending

Let us turn to the second largest category of budget outlays, national defense. Here we should acknowledge at the outset that there is a broad-based agreement on the need to expand U.S. national defense spending. Both the Carter and Reagan budgets projected significant growth in defense spending in real terms for each of the five fiscal years 1982-1986. The Council of Economic Advisers (CEA) stated in its annual report accompanying the President's 1982 Economic Report, "any economic effects...must be assessed in the context of the overriding need for maintaining the level of defense spending necessary for national security."

As would be expected, there has been considerable disagreement over the specifics of the buildup, including the question of how rapid an expansion in military spending is desirable. But it should be recognized that none of this is a debate between hawks and doves. Among the specific questions raised is the economic feasibility of the currently contemplated schedule of military outlays. Moreover, the

The defense buildup is not a "hawk vs. dove" issue so much as it is a question of economic feasibility

1981-82 recession has resulted in such substantial amounts of excess capacity in American industry that, at least for the next year or two, there is likely to be adequate capacity to meet military and civilian needs. But it is useful to look beyond, to the middle of the decade, when significant economic growth may coincide with the peak of the military buildup. In such circumstances, capacity questions would arise. The CEA annual report deals with that eventuality, pointing out three results of the defense buildup that can be anticipated:

1. The substantial transfer of resources in the durable goods sector to defense production may increase relative prices in some of the affected industries. Both the Department of Defense and private purchasers may have to pay more for goods from these industries. This premium is likely to increase with the size of the defense budget.
2. Increased demand may produce delays in the delivery of military goods. Delivery timetables that seem realistic today may become obsolete as producers try to accommodate both the defense buildup and the expansion in civilian investment.
3. Some crowding out of private investment may occur. Defense procurement uses many of the same physical resources needed for private investment, and the Defense Production Act gives defense priority in the market place. Some private firms may turn to foreign sources, while others may cancel or postpone plans for expansion.

When we examine the details of the military budget, we find that the concentration of the planned military increases within procurement and research and development implies weapon production growth rates more rapid than those which occurred at the peak of the Vietnam buildup. Moreover, the present expansion occurs after a decade of steady reductions in the defense industrial base.

A private economic consulting organization, Data Resources, Inc. (DRI), pointed out:

> ...the combination of the increasing defense shares and the acceleration in growth rates raises concerns about industrial capabilities and spillover impacts on the economy.[1]

DRI goes on to note that, with the implementation of significant investment

programs in both plant and equipment and skilled labor forces, the problems of price pressures, bottlenecks and crowding out of civilian demand "could be constrained to isolated instances." See Table 5 for some examples of extremely rapid growth rates in future defense industry requirements. Over the six-year period 1982-87, double-digit increases in annual output are shown for many industries, ranging from semiconductors to computers. The DRI conclusion is that the uncertainties about the capabilities of the defense industrial base and its linkages to other critical economic variables "will continue to cloud decisions regarding the defense budget."

A more recent Data Resources report is even less sanguine, pointing out that, since 1948, there has never before been a period of sustained growth in real defense spending such as that now planned. This more recent study concludes that the projected requirements for such large increases in defense output raise "obvious" questions about the ability of industry to meet them without adverse implications in terms of costs and leadtimes.[2] A variation of that theme appears in a recently released study by the U.S. Department of Commerce which reminds us that defense expenditures do not affect all industries equally, but have "highly concentrated industrial impacts."[3]

Defense expenditures do not affect all industries equally; they have "highly concentrated industrial impacts"

The Commerce Department examined a somewhat different time period than did DRI, but the conclusions are fairly similar. For most of the 58 major defense supplying industries which it studied, the Department of Commerce reported that existing capacity plus planned increases are sufficient to supply the projected military and civilian

TABLE 5
Projected Increases in Output in Major Defense Supplying Industries, 1982-1987
Average annual real percentage growth in projected output

Industry	Annual Increases In Total Output, 1982-87	In Defense Output, 1982-87
Radio & TV communication equipment	11.2%	15.7%
Aircraft	12.8	18.6
Aircraft engines & parts	13.0	16.3
Aircraft parts & equip., n.e.c.	11.2	14.7
Complete guided missiles	11.5	15.2
Electronic components, n.e.c.	11.2	17.2
Tanks & components	22.6	27.1
Ammunition, excluding small arms, n.e.c	15.0	15.2
Motor vehicles parts and accessories	6.3	20.5
Motor vehicles	6.7	27.8
Other ordnance, accessories	13.5	14.4
Communications, excluding radio and TV	6.9	10.3
Semiconductors	13.7	20.2
Miscellaneous machinery	6.9	15.3
Electronic computing equipment	12.6	16.8
Aluminum rolling & drawing	7.9	17.9
Miscellaneous plastic products	8.5	17.3
Primary aluminum	7.3	17.1
Plastic materials & resins	8.8	17.8
Special dies, tools & acc.	8.2	15.8
Telephone & telegraph equip.	11.5	16.4
Metal stampings	7.0	18.6
Industrial trucks & tractors	9.9	14.1
Machine tools, metal cutting	9.2	15.7
Iron and steel foundries	4.3	13.2

Source: Compiled from Data Resources, Inc.

demands through 1985. However, the Department said that, should further capacity expansion not take place in some of these industries, meeting projected 1985 requirements would mean using outmoded, economically inefficient capacity, which would increase costs and prices. For example, requirements for lead smelting and refining are projected to rise by 12 percent

from 1979 to 1985, but economically efficient capacity is estimated to decline by 4 percent. Likewise, requirements for brass, bronze, and copper foundries are shown to increase by 32 percent, but economically efficient capacity is expected to rise by 25 percent (see Table 6). How will all this balance out?

The Commerce study reported that some of our basic metal processing industries will likely need to increase their dependence on foreign sources of supply in order to meet the stepped-up military demands. For example, the electrometallurgical products industry (which was specifically noted because of its "qualitative importance to

Meeting 1985 defense requirements could mean using outmoded, inefficient capacity—thus increasing costs and prices

defense") met 27.6 percent of its needs with imports in 1979. That key industry is expected to increase that dependency to 45 percent in 1985. Likewise, zinc smelting and refining is anticipated to increase its import dependency from 33.4 percent in 1979 to 45 percent in 1985. Imports of miscellaneous refined nonferrous metals are estimated to comprise 66 percent of the industry in 1985, compared to 55.7 percent in 1979 (see Table 7). It is ironic to note the matter-of-fact way in which the Commerce Department reports such increased foreign dependence for some of the key defense-producing industries. On many other occasions, the hoary national security argument is trotted out to justify a host of subsidies to sectors of the economy far less closely related to defense output.

The point of these data should not be misunderstood. Drawing attention to the economic impacts of the contemplated expansion of military outlays does not call in question the desirablity of the expansion but, rather, its feasibility and cost in the

TABLE 6
Demand and Supply Balance of Selected Defense-Intensive Industries, 1979-1988

Industry	Growth in Output Requirements 1979-1985	Potential Increase in Supply: Economically Efficient[a]	Potential Increase in Supply: Maximum Attainable[b]
Guided missiles and space vehicles	86%	86%	98%
Ammunition, except for small arms, n.e.c.	50	119	133
Tanks and tank components	83	83	107
Small arms	7	40	50
Small arms ammunition	82	72	89
Ordnance & accessories, n.e.c.	33	112	128
Iron and steel forgings	19	33	39
Lead smelting and refining	12	−4	11
Aluminum production and refining	15	16	16
Nonferrous rolling and drawing, n.e.c.	33	33	37
Brass, bronze and copper foundries	32	25	37
Electronic computing equipment	83	106	122
Semiconductors and related devices	76	106	116

[a]Based on concept of preferred capacity, defined as the level of operations plant managers prefer not to exceed because of considerations of cost and economic efficiency.

[b]Based on concept of practical capacity. Assumes no material, utility, or labor shortage and no consideration of increased pay or other input costs as limiting factors.

Source: Compiled from U.S. Department of Commerce, Bureau of Industrial Economics.

TABLE 7
Changing Import Dependence of Selected Defense Industries

Industry	Imports as Percent of Total Supply: 1979	Imports as Percent of Total Supply: 1985 est.
Iron and ferroalloy ores mining	25.0	28.1
Small arms	9.4	10.6
Blast furnaces and steel mills	10.1	13.0
Electrometallurgical products	27.6	45.0
Lead smelting and refining	8.8	11.0
Zinc smelting and refining	33.4	45.0
Aluminum production and refining	8.9	10.0
Refining of nonferrous metals, n.e.c.	55.7	66.0
Machine tools, metal-cutting types	17.2	23.0
Machine tools, metal-forming types	9.2	13.6
Ball and roller bearings	10.5	14.0
Instruments to measure electricity	8.9	13.0
Semiconductors and related devices	20.6	30.0
Electronic components, n.e.c.	8.0	11.5
Optical instruments and lenses	14.1	19.5

Source: Compiled from U.S. Department of Commerce, Bureau of Industrial Economics

period contemplated. An implicit assumption arises from these concerns: any adjustment of scheduled defense outlays to conform more closely with expected domestic production capabilities would result in slowing down the rate of increase in defense spending in the next few years and thus lower the projected deficits of the federal government.

Adjusting defense outlays in the next few years to conform with production capacity would lower the federal government's projected deficits

Conclusions

In responding to the concerns over the continuing large federal deficits projected for the next several years, I have emphasized the desirability of another hard look at the spending side of the budget. Unlike another round of tax increases, restraining government expenditures is entirely consistent with the efforts of President Reagan to strengthen the private sector by reducing the size of government.

Three major areas of the budget appear to be promising candidates for further pruning of outlays—above and beyond the Administration's important efforts to ferret out low priority items and to curb waste:

1. *The so-called entitlements.* These open-ended commitments on the budget range from social security and medicare to medicaid, welfare, veterans' pensions, and the retirement systems for federal employees, military and civilian. In the short run, reductions could be made in the generous formulas for computing annual cost-of-living increases (the COLA clauses) contained in many of these programs. More fundamental changes probably will not be made until the public recognizes the extent to which these "social insurance" programs have taken on a subsidy or welfare aspect—e.g., providing benefits far more generous than those that would result from basing the payments solely on employee/employer contributions plus earnings on those contributions. Making benefits subject to income taxes—as is now done with private retirement benefits—would reduce the net subsidy payment, especially to those taxpayers with substantial amounts of other income.
2. *The defense budget.* Official projections of future military outlays, in real terms, have risen successively during the last two years from 5% to 7% to 9% or more per annum. I find little justification offered of the economic feasibility of this sharply upward movement. A tough-minded attitude should be taken to the military budget, comparable to the treatment of many civilian spending activities of the federal government. Reducing the extent of cost overruns and bottlenecks in defense production will help to maintain the necessary support for the strengthened national defense that is needed in the dangerous world in which we live.

A tough-minded attitude should be taken to the military budget, comparable to the treatment of many civilian spending activities

Because of the potential capacity problems, a given cutback in nominal military spending would actually result in less than a proportional reduction in real procurement outlays. This would come about because of reduced price pressures on military purchasing generally.

3. *Imbedded subsidies.* Advocates of smaller federal budgets typically focus on entitlements and/or defense spending because these are the two largest categories. However, it does not take a great deal of research to discover a third category of the budget, "all other." Contrary to widespread belief, not all of the items in this part of the budget are social programs, nor have they been cut to the bone. Generous programs such as subsidies to dairy and tobacco farmers and sugar producers quickly come to mind. There is no serious justification for these subsidies and many others like them in

other departments of the federal government. Such special benefits to specific segments of the society are in the budget simply because of the political muscle of the producer or other special interest groups supporting them. The Congressional Budget Office has prepared several comprehensive listings of potential budget cuts that could be made. There is no shortage of information. All that is lacking is the will to cut more.

On reflection, we need to realize that at times—such as earlier this year—the failure to curtail federal spending leads to pressures for tax increases. Given the outlook for rising deficit financing, if we are to avoid further reversals of the 1981 tax cuts, more of the existing sacred cows in the federal budget should be taken out of pasture and led to slaughter.

More of the existing sacred cows in the federal budget should be taken out of pasture and led to slaughter

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Notes

1. George F. Brown, Jr., "Defense and the Economy: An Analysis of the Reagan Administration's Programs," *Data Resources U.S. Review*, May 1982.
2. Data Resources, Inc., *Defense Economics Research Report*, August 1982, p. 7.
3. U.S. Department of Commerce, Bureau of Industrial Economics, *Sectoral Implications of Defense Expenditures*, August 1982, p. 4.